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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

NYNEX

May 25, 1994

Ex Parte

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, D.C. 20554

Re: CC Docket Nos. 93-193 and 93-179

Dear Mr. Caton:

Yesterday, J. DiBella, K. Richards, and I, representing the NYNEX Telephone Companies (NTCs) had meetings with R. Baca, Legal Advisor to Commissioner Quello, and R. Milkman, Senior Advisor to Chairman Hundt, regarding the items captioned above. Due to the late hour of the meetings, an *ex parte* notice could not be filed until today.

The attached material served as the basis for the presentation and the ensuing discussion. Any questions on this matter should be directed to me at either the address or the telephone number shown above.

Sincerely,

Ken. Rust

Attachments

cc: R. Baca
R. Milkman

Add-Back of Sharing and Lower Formula Adjustments

5/24/94

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History of Add-Back Issue

- Issue Has Been Discussed Since 1991
- In 1992 and Early 1993, FCC Accounting Division Confirmed That ROR Should Be Normalized Through Add-Back
- NYNEX Normalized Its 1992 ROR By Removing LFA Revenues
- FCC Investigated 1993 Access Tariffs On Issue of Add-Back
- FCC Issued NPRM On July 6, 1993 To Clarify Its Rules On Add-Back

Add-Back Is Consistent With Price Cap Rules and ROR Reporting Rules

- Add-Back Is Necessary To Enforce ROR Limits
  - » Provides Consumers With The Correct Amount Of Sharing Revenues
  - » Prevents LECs From Earning Less Than Minimum Needed To Stay In Business
- Form 492 Report Requires Normalization
  - » NPRM Clarified Existing Rule
  - » FCC Position Has Been Consistent Since 1991

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D. C. 20554

In the Matter of	)	
	)	
1993 Annual Access	)	CC Docket No. 93-193
Tariff Filings	)	

DIRECT CASE OF THE NYNEX TELEPHONE COMPANIES

New York Telephone Company
and
New England Telephone and
Telegraph Company

Edward R. Wholl
Campbell L. Ayling
Joseph Di Bella

120 Bloomingdale Road
White Plains, NY 10605
914/644-5637

Their Attorneys

Dated: July 27, 1993

ISSUE NO. 2: How should price cap LECs reflect amounts from prior year sharing or low-end adjustments in computing their rates of return for the current year's sharing and low-end adjustments to price cap indices?

ANSWER: As the Commission noted in the Designation Order, the NTCs normalized their 1992 interstate rate of return for purposes of calculating their 1993 sharing obligation by removing the 1992 revenues associated with the lower formula adjustment ("LFA") for 1991 underearnings.[1] The NTCs demonstrated in the Description and Justification (D&J) to their 1993 Annual Access Tariff filing and in their subsequent Reply to the Petitions to Reject, Suspend and Investigate their 1993 Annual Access Tariff Filings that the local exchange carriers ("LECs") must normalize their 1992 rates of return to comply with the earnings limitations of the Price Cap system and to report their rates of return consistently with the Commission's rules and regulations.[2] In the Designation Order, the Commission also noted that it was addressing the issue of normalization of rate of return under Price Caps in a notice of proposed rulemaking.[3] The proposed rule would require the LECs to normalize, or "add-back," the effect on rates of return

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1 Designation Order, paras. 30-31.

2 See NYNEX Telephone Companies Tariff FCC No. 1, Transmittal Nos. 176, 186, 201, filed April 2, May 3, & June 14, 1993, Description and Justification, pp. 41-43; 1993 Annual Access Tariff Filings, Reply of the NYNEX Telephone Companies, filed May 10, 1993, Appendix A.

3 Designation Order at para. 32.

of both rate increases and rate reductions under price caps to share or increase earnings from earlier years.[4]

In the NTCs' view, the NPRM simply clarifies a requirement that is implicit in the Commission's Price Cap rules. In the following sections, the NTCs will demonstrate that normalization is required by the Commission's rules and that it is essential for a reasonable calculation of exogenous cost changes in the annual tariff filings.

1. The Price Cap System Would Be Legally Invalid If The Commission Did Not Require The LECs To Normalize Their Rates of Return In Computing Sharing Obligations and Lower Formula Adjustments.

If the Commission did not interpret its Price Cap rules to require the LECs to normalize their rates of return through "add-back" of sharing and LFA amounts, the Price Cap system would be legally invalid. This would occur because normalization is the only way that the Commission can enforce the upper and lower earnings limitations that are critical components of its Price Cap system.

The Price Cap sharing and LFA mechanisms replaced the rate of return enforcement rules that the court invalidated in AT&T v. FCC.[5] In that case, the court found that the automatic refund rules in 47 C.F.R. Section 65.700 et seq were inconsistent with the rate of return prescription that the rules

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4 Cf. Rate of Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179, Notice of Proposed Rulemaking, FCC 93-325, released July 6, 1993.

5 American Tel. & Tel. Co. v. FCC, 836 F.2d 1386 (D.C. Cir. 1988).

were intended to enforce.[6] The automatic refund rule required the LECs to make refunds for years in which their earnings exceeded the prescribed rate of return, plus a buffer, while it provided no mechanism for the LECs to recoup shortfalls for years in which their earnings were below the prescribed rate of return. The court found that this produced a "systematic bias" that would depress carrier earnings below the prescribed rate of return over the long run. Since the Commission had stated that the prescribed rate of return was the minimum return necessary for a carrier to stay in business, the court invalidated the automatic refund rule because it was inconsistent with the Commission's own understanding of its rate of return prescription.[7]

The Commission dealt with these issues in the LEC Price Cap Order by establishing a "backstop" mechanism to protect against excessively high or low earnings. While it prescribed a rate of return of 11.25 percent for rate setting purposes, it decided that carriers could retain 100 percent of earnings up to 12.25 percent as an incentive to become more efficient.[8] To provide a balance of risk and reward, the

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6 Id. at 1390-91.

7 Accord, Ohio Bell Tel. Co. v. FCC, 949 F.2d 864 (6th Cir. 1991).

8 LEC Price Cap Order at para. 123. The sharing mechanism also requires a LEC to share 50 percent of earnings between 12.25, percent up to a maximum of 16.25 percent, at which point the LEC would share 100 percent of earnings. This would prevent the carriers from earning more than 14.25 percent after making sharing adjustments. Id. at paras. 124-125.

Commission adopted the LFA mechanism, which allows the LECs to increase their price cap indexes to the extent that their earnings in any given year are below 10.25 percent. Although this is 1 percentage point below the prescribed rate of return, the Commission found that it would not be confiscatory, because it would still allow most companies to continue to attract capital and to maintain service.[9] The Commission found that "a LEC with earnings below 10.25 percent is likely to be unable to raise the capital necessary to provide new services that its customers expect. It may even find it difficult to maintain existing levels of service."[10] Therefore, the Commission adopted the LFA mechanism to ensure that the LECs could earn the minimum necessary return. If the Commission applied the LFA in a way that would tend to drive earnings below the LFA level, the Commission would contradict its own rate of return findings in the same way that it did in AT&T v. FCC.

A failure to require normalization of rate of return in computing sharing or LFA amounts would do exactly that. This is illustrated in Attachment A, which shows the effect of using actual rates of return to compute sharing obligations and LFA amounts for LECs whose earnings are above or below the earnings limitations. In order to isolate the effect of normalization, the examples assume that a carrier's earnings remain at the same level each year absent sharing or LFA. A LEC earning 8 percent in the base year would be

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9 Id. at para. 165.

10 Id. at para. 148.

entitled to an LFA in the second year equal to the difference between its rate of return in the base year and the lower adjustment mark (10.25 percent). All other things being equal, the LEC would earn 10.25 percent in the second year, including LFA revenues. Since the LEC must reverse the LFA in the third year, its earnings would revert to 8.0 percent if it used its actual rate of return for year 2 (10.25 percent) to determine its eligibility for an LFA in year 3. This would trigger another LFA in the fourth year. As illustrated in the further examples and the graph in Attachment A, this would create the "see-saw" pattern of earnings that the Commission described in the NPRM. Thus, if the Commission did not allow an underearning LEC to normalize its earnings by removing the effect of an LFA, it would tend to drive the LEC's earnings below the level that the Commission has defined as confiscatory.

Attachment A also illustrates how a failure to normalize rates of return would undermine the Price Cap earnings limitations on the high end as well. A LEC earning at 17 percent in the first year would refund 100 percent of its earnings above 16.25 percent and 50 percent of its earnings between 12.25 percent and 16.25 percent, reducing its effective rate of return to 14.25 percent in the second year, all other things being equal. However, if the LEC used its actual rate of return in the second year, including the rate reduction for sharing, to compute its sharing obligation for the third year, it would only share 50 percent of earnings between 14.25 percent and 12.25 percent. Since it would also reverse the second year sharing amount, its earnings would increase to 16.0

percent. Thus, the "see-saw" effect would produce average earnings over the effective upper limit of 14.25 percent. In addition, this see-saw effect would prevent the LEC from sharing the correct amount even if its earnings were not above the cap.

The charts in Attachment A also demonstrate that LECs will achieve the earnings levels intended by the Price Cap Rules if they normalize their rates of return. Normalization allows a LEC earning 8.0 percent to incorporate an LFA in each year's annual tariff filing that is sufficient to bring its earnings to the lower adjustment mark of 10.25 percent. Normalization also requires a LEC earning 17 percent to share the amounts necessary to bring its earnings to the upper limit of 14.25 percent. Thus, normalization is absolutely essential to maintain the integrity of the Price Cap earnings limits.

2. Normalization of Earnings is Required By the Commission's Rules on Reporting Rates of Return.

The NPRM correctly notes that when the Commission adopted its Price Cap rules, it did not modify the requirement that the LECs report earnings on their Form 492 rate of return reports using normalized revenues.[11] The instructions for the Form 492A Report state that reported revenues should include revenues earned during the report period (Instruction F of the General Instructions). When the Commission established its rules for the earnings reports, it required the LECs to

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11 NPRM at paras. 8, 10.

report earned revenues rather than unadjusted "booked" revenues so that revenues would relate to the appropriate period and so that they would be consistent with how expenses and other items are reported on Form 492.[12] When a LEC collects revenues for services that it has provided in a prior period, (so-called "backbilling") it does not report the revenues for the period in which they are received, because the revenues were "earned" in the period during which the services were provided. Therefore, the LEC deducts those revenues from its booked revenues during the reporting period. Similarly, when a LEC gives a customer a credit or refund for overbillings in past periods, it normalizes its revenues in the reporting period by adding back the amount of the overbilling credit.

These principles are directly applicable to LFA and sharing amounts. An LFA is like backbilling, because the LEC receives the LFA revenues in the reporting period to compensate it for underearnings in the prior period. Thus, the LFA is "earned" in the past period, and it must be removed from revenues in the reporting period to reflect revenues earned during the reporting period. Sharing is like a credit or refund, because it is a reduction in revenues to return to ratepayers a portion of revenues that were overearned in the prior period. Those sharing revenues must be added back to the revenues in the reporting period to reflect revenues that would

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12 <u>See</u> Amendment of Part 65, Interstate Rate of Return Prescription: Procedures and Methodologies to Establish Reporting Requirements, <u>Report and Order</u>, 1 FCC Rcd 952, 957 (1986).

have been received in the reporting period absent the exogenous adjustment for sharing.

The NTCs' 1992 LFA represented the revenues necessary to increase their 1991 earnings to the lower formula mark. Therefore, to determine the revenues earned during the 1992 reporting period, the NTCs had to normalize their revenues to exclude the effect of the lower formula adjustment for 1991 earnings that was included in the 1992 rates. For the 1993 reporting period, the NTCs intend to "add-back" the revenue reduction that they included in their 1993/94 rates to reflect sharing for overearnings in 1992. This normalization of 1993 earnings will set the appropriate standard for determining whether a LFA or a sharing obligation should be included in the 1994 annual access tariff filing.

3. The Pending Rulemaking Simply Clarifies The Fact That The Commission's Rules Already Require Normalization Of Rates Of Return.

The Commission's decision to clarify the normalization requirement in the NPRM does not imply that normalization is not required by the current rules. While some parts of the Commission's Price Cap rules are very explicit, such as where they provide formulas for computing changes to price cap indexes, other parts are descriptive in nature. The latter type of rule places the burden on the LEC to show that its tariffs are consistent with the words and intent of the rule. This is the case with respect to the rules governing most exogenous adjustments, including sharing and LFAs. For example, the rule requiring exogenous treatment of changes in the Separations Manual do not provide any instructions as to how to calculate the effect of separations changes.[13] Section 61.49(a) requires the LEC to submit sufficient data to support its tariff filing. Therefore, in calculating an exogenous cost adjustment for separations changes, the LEC must show that its methodology is consistent with the Commission's accounting and cost allocation rules and it must provide sources for its data. Similarly, the rules require the LECs to make exogenous adjustments "as may be necessary to reduce PCIs to give full effect to any sharing of base period earnings" required by the Commission's rules, and they permit "retargeting the PCI to the level specified by the Commission for carriers whose base year earnings are below the level of the lower adjustment mark."[14] These general descriptions place the burden on the LEC to show that its method of calculating exogenous adjustments for sharing and LFAs is

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13 See 47 C.F.R. Section 61.45(d)(1)(iii).

14 See 47 C.F.R. Sections 61.45(d)(1)(vii), 61.45(d)(2). There is some uncertainty concerning the exact wording of Section 61.45(d)(2). As adopted in the LEC Price Cap Order, this section required the LECs to make exogenous adjustments for sharing as "required by the sharing mechanism set forth in the Commission's Second Report and Order in Common Carrier Docket No. 87-313, FCC 90-314, adopted September 19, 1990" (i.e., the LEC Price Cap Order). See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990), Appendix B, p. 6. We are aware of no subsequent amendments to this section. However, the bound version of the CFR omits the reference to the LEC Price Cap Order and requires that sharing comply with the sharing mechanism "set forth in 47 CFR parts 61, 65 and 69." Since none of those parts provides a description of the sharing mechanism, the LEC must in any event refer to the LEC Price Cap Order to develop a reasonable method of calculating its sharing obligation.

consistent with the Price Cap rules and with the intent of the orders implementing those rules.

As demonstrated above, it is impossible to compute the correct sharing or LFA amounts without normalizing rates of return for the previous period. While the LEC Price Cap Order did not discuss normalization, it also did not eliminate the continuing requirement that the LECs report earned revenues in their Form 492 rate of return reports.[15] It also did not alter the rule that the LECs are responsible for demonstrating the reasonableness of their tariff filings and for submitting sufficient information to support their filings.

The NTCs met these standards by excluding LFA amounts from their rates of return for purposes of computing their 1993 sharing obligation. Their tariffs are completely consistent with the terms and intent of the Commission's rules.

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15 See LEC Price Cap Order, para. 373. This issue was also addressed indirectly in the LEC Price Cap Reconsideration Order (Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Order on Reconsideration, 6 FCC Rcd 2637 (1991)). In the Price Cap Proceeding, the United States Telephone Association ("USTA") pointed out the sawtooth effect in opposing AT&T's suggestion that the PCI adjustments to bring a LEC's earnings to the LFA mark should be one-year adjustments. USTA argued that the LFA should be permanent, to prevent the LEC from earning less than its cost of capital in the year that the LFA was reversed. See Opposition of USTA to Petitions for Reconsideration, CC Docket 87-313, filed December 21, 1990. The Commission responded by pointing out that "if a LEC continues to operate below the lower adjustment mark, the LEC will be subject to a subsequent PCI adjustment." Id. at n. 166. If the LFA were a one-year adjustment, the only way that the LEC could receive an LFA in the subsequent year, as the Commission intended, would be to remove the LFA revenues from its reported rate of return for the previous year.

MECHANICS OF FEDERAL PRICE CAPS
SHARING AND LOWER FORMULA ADJUSTMENT

Below are several simple examples that outline the two contending methods of calculating the sharing and lower formula adjustment mechanism (LFAM). For the sake of simplicity, we assume that calendar year and tariff year periods are identical. In addition, we also assume in each period realized productivity offset levels that will produce rates of return identical with the first period. The intent of these assumptions is to identify rate of return variations in each year purely as a product of sharing/LFAM exogenous adjustments.

1. Lower Formula Adjustment Mechanism based on earnings including previous LFAM adjustments.

	Gross ROR	LFAM	Adjustments	Net ROR
Base Year(1)	8.0	N/A	0	8.0
Year 2	8.0	10.25	+2.25	10.25
Year 3	10.25	10.25	-2.25	8.0
Year 4	8.0	10.25	+2.25	10.25
Year 5	10.25	10.25	-2.25	8.0
Year 6	8.0	10.25	+2.25	10.25
Year 7	10.25	10.25	-2.25	8.0

In this example, the LEC realizes base year (year 1) earnings of 8.0 percent. In year 2, the LEC is entitled to an exogenous adjustment of +2.25 percent in order to prospectively recoup the shortfall from the base year. If the underlying earnings in year 2 are the same as that in the base year (as assumed above), then the LEC earns 10.25 percent in year 2. In year 3, the LEC having earned 10.25 percent in year 2 is not entitled to an exogenous adjustment. However, if the exogenous adjustment from year 2 is treated as a temporary one, then it must be reversed in year 3. Assuming the underlying earnings in year 3 are the same as that of the base year and year 2, the LEC earns only 8.0 percent in year 3. In year 4, the LEC is once again entitled to an exogenous adjustment and earns 10.25 percent in that year.

The effect of this mechanism is a sawtooth pattern of earnings represented by the Net ROR column above. Specifically, an exogenous adjustment is implemented in year 2 increasing year 2 earnings, and reversed in year 3, reducing year 3 earnings. However, since the adjustment in year 2 is included in the evaluation of earnings for year 2 adjustments, no new adjustment is made in year 3. This depresses year 3 earnings triggering a year 4 adjustment.

Now consider an alternative view where exogenous adjustments are treated as temporary, but are based on prior year earnings not including exogenous adjustments.

2. Lower Formula Adjustment Mechanism based on base earnings excluding previous LFAM adjustments.

	Base ROR	Gross ROR	LFAM	Adjustments	Net ROR
Base Year(1)	8.0	8.0	N/A	0	8.0
Year 2	8.0	8.0	10.25	+2.25	10.25
Year 3	8.0	10.25	10.25	-2.25+2.25	10.25
Year 4	8.0	10.25	10.25	-2.25+2.25	10.25
Year 5	8.0	10.25	10.25	-2.25+2.25	10.25
Year 6	8.0	10.25	10.25	-2.25+2.25	10.25
Year 7	8.0	10.25	10.25	-2.25+2.25	10.25

In this example, the exogenous adjustments are temporary, but each year the underlying base ROR causes an upward exogenous adjustment to nullify the expiration and reversal of the prior year's adjustment. Consequently, the LEC will earn at the lower formula adjustment mark.

The analysis above can be applied to the sharing mechanism.

3. Sharing mechanism based on earnings including previous sharing adjustments with no interest.

	Gross ROR	Sharing Trigger	Adjustments	Net ROR
Base Year(1)	17.00	N/A	0	17.00
Year 2	17.00	>16.25 100% 12.25 50%	-2.75	14.25
Year 3	14.25	*	+2.75-1.0	16.00
Year 4	16.00	*	+1.0-1.875	15.125
Year 5	15.125	*	+1.875-1.438	15.562
Year 6	15.562	*	+1.438-1.656	15.344
Year 7	15.344	*	+1.656-1.547	15.453

The method used in this example matches that used in the lower formula adjustment mechanism in 1. above.

In this example, the LEC realizes base year (year 1) earnings of 17.00 percent. In year 2, the LEC is liable for an exogenous adjustment of 2.75 percent in order to prospectively return to the ratepayer 100% of the base year's earnings above 16.25%, and one half of the base year's earnings between 12.25% and 16.25%. If the underlying earnings in year 2 are the same as that in the base year (as assumed above), then the LEC earns 14.25 percent in year 2. In year 3, the LEC having earned 14.25 percent in year 2 is liable for another exogenous sharing adjustment, but this adjustment is smaller than might otherwise be expected since it is based on 14.25 percent earnings and not the underlying 17.00 percent. The exogenous adjustment from year 2 is reversed in year 3, and the LEC earns 16.0 percent. In year 4, the LEC is once again liable for an exogenous sharing adjustment and earns 15.125 percent in that year. This process continues through year 7. Notice that since the underlying earnings for each year are 17.00 percent, this method of computing exogenous sharing adjustments allows the LEC to retain more of its underlying earnings. That is, the ratepayer is entitled to 2.75 percent sharing each year, but never receives it, except in year 2.

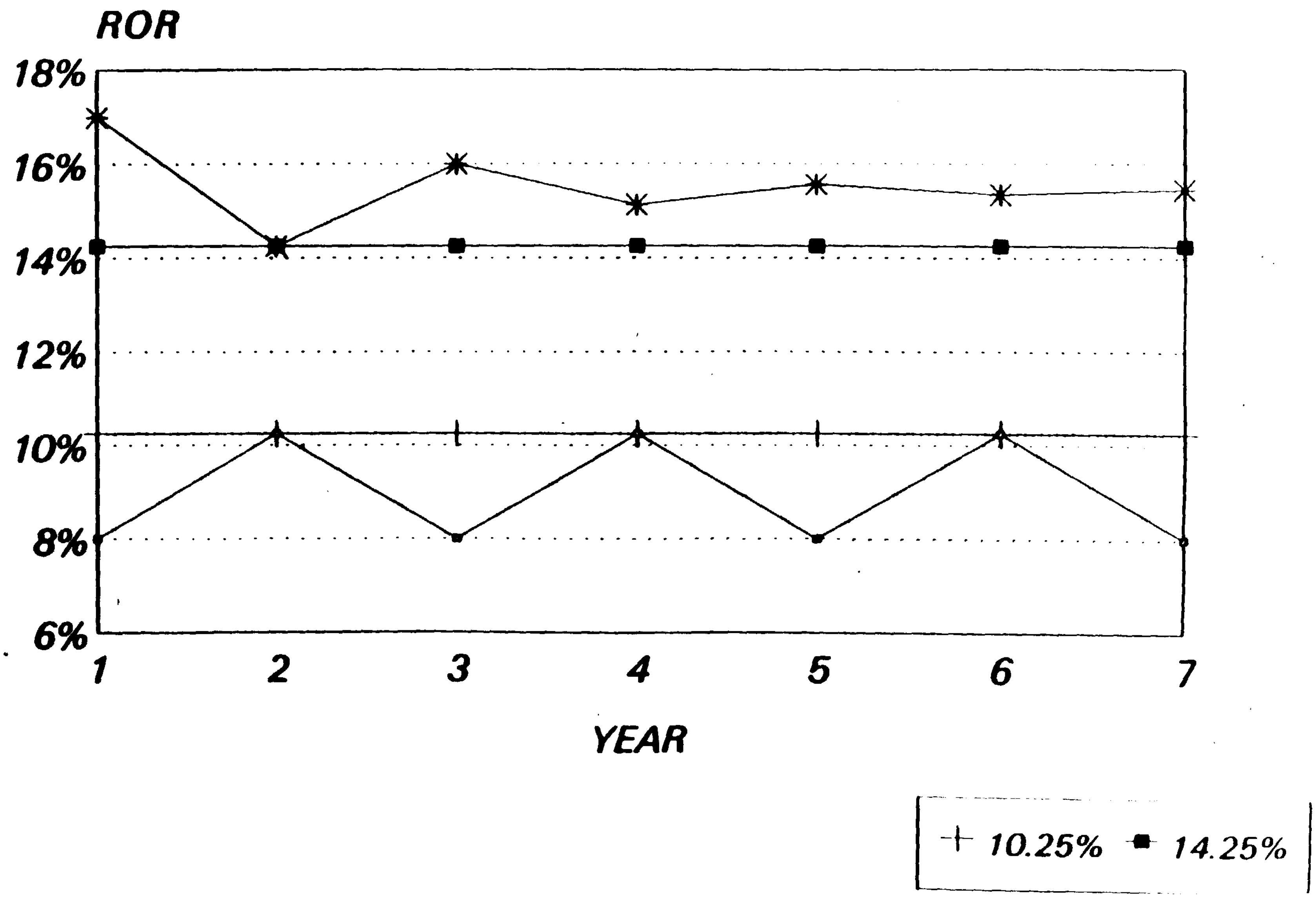
Now consider the alternative view where exogenous adjustments are treated as temporary, but are based on prior year earnings *not including* exogenous adjustments. This matches the LFAM method in 2. above.

4. Sharing mechanism based on earnings excluding previous sharing adjustments with no interest.

	Base ROR	Gross ROR	Sharing Trigger	Adjustments	Net ROR
Base Year(1)	17.00	17.00	N/A	0	17.00
Year 2	17.00	17.00	> 16.25 100% 12.25 50%	-2.75	14.25
Year 3	17.00	14.25	•	+2.75-2.75	14.25
Year 4	17.00	14.25	•	+2.75-2.75	14.25
Year 5	17.00	14.25	•	+2.75-2.75	14.25
Year 6	17.00	14.25	•	+2.75-2.75	14.25
Year 7	17.00	14.25	•	+2.75-2.75	14.25

In this last example, the exogenous adjustments are temporary, and each year analysis of the underlying rate of return of 17.00 percent causes a downward sharing adjustment to nullify the expiration and reversal of the prior year's adjustment. As a consequence, the LEC earns 14.25 percent. The ratepayer and the LEC receive each year their fair share of the earnings (with interest to compensate ratepayers for the time value of money). This appears more in line with the Commission's intent in the Price Cap and subsequent orders.

FORM 492A - SHARING AND LFA



BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D. C. 20554

In the Matter of	)	
	)	
Price Cap Regulation of Local Exchange Carriers	)	CC Docket No. 93-179
	)	
Rate of Return Sharing And Lower Formula Adjustment	)	

REPLY COMMENTS OF THE NYNEX TELEPHONE COMPANIES

New York Telephone Company ("NYT") and New England Telephone and Telegraph Company ("NET"), collectively the "NYNEX Telephone Companies" or "NTCs", hereby file their Reply to the Comments that were filed in response to the Commission's Notice of Proposed Rulemaking ("NPRM") in the above referenced proceeding.[1]

I. INTRODUCTION AND SUMMARY

Several parties have attempted to complicate an issue that is really quite simple: should the local exchange carriers ("LECs") normalize their rates of return by "adding-back" the effect of sharing and lower formula adjustment ("LFA") revenues for purposes of computing their sharing obligations and LFAs

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1 Rate of Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179, Notice of Proposed Rulemaking, FCC 93-325, released July 6, 1993. A list of the parties that filed Comments, including the abbreviations used herein, is attached as Exhibit 1.

for the subsequent period? The NPRM demonstrates that normalization is not only logical, but necessary, to carry out the earnings limitations of the Commission's price cap system. Non-normalized rates of return would give an incorrect picture of a LEC's performance by artificially lowering a LEC's rate of return for sharing amounts and by artificially inflating a LEC's rate of return for LFA amounts.

The NPRM's conclusions are supported and illustrated in a series of mathematical charts. Several commenters challenge the Commission's conclusions by offering alternative analyses. These analyses, however, are riddled with errors and they prove nothing.

Several commenters argue that the Commission must equate sharing with refunds in order to require normalization. This is incorrect. Although sharing is not a refund, it still must be based on normalized rates of return to produce the amount intended by the price cap rules.

The NTCs disagree with the commenters who argue that the NPRM proposes to change the rules on calculating rates of return, rather than to clarify the requirements of the existing rules. The Commission never amended the rules that require the LECs to report "earned", i.e., normalized, rather than booked revenues on their Form 492 rate of return reports. Although the amended Form 492 does not contain a line item that adds sharing or removes LFA amounts, it still requires the LECs to adjust the revenues on line 1 by the amount of sharing or LFA revenues, just as it requires the LECs to increase line 1 revenues for FCC-ordered refunds and for credits given to customers for overbillings in prior periods. Because the NPRM merely clarifies existing requirements, the commenters who argue that it would constitute retroactive rulemaking to apply the rules to the pending investigation of the 1993 Annual Access Tariffs are incorrect.

Some of the commenters argue that add-back will reduce the incentives for the LECs to become more efficient. The commenters are wrong. Add-back merely maintains the existing efficiency incentives by enforcing the rate of return limitations that the Commission adopted in the LEC Price Cap Order.[2] The NTCs agree with the commenters who believe that the Commission should increase the incentives for the LECs to become more efficient by eliminating sharing entirely when the Commission reviews its price cap rules.

II. THE COMMENTERS FAIL TO UNDERMINE THE COMMISSION'S CONCLUSION THAT ADD-BACK IS NECESSARY TO CALCULATE SHARING OBLIGATIONS AND LOWER FORMULA ADJUSTMENTS

The NPRM demonstrates in a straight-forward and convincing manner that add-back is necessary to enforce the earnings limitations of the price cap plan and that non-normalized rates of return produce an inaccurate picture of earnings for purposes of computing sharing and LFA amounts.[3] Several commenters presented alternative charts in an attempt to show that add-back distorts the LECs' earnings levels and

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2 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990).

3 See NPRM, Appendix A.

produces the wrong amount of sharing or LFA.[4] These charts are riddled with errors and they do nothing to rebut the Commission's analysis.

Bell Atlantic uses the analysis in its charts 1-1 and 1-2 to argue that add-back forces a LEC to share additional amounts year after year in excess of the 50 percent sharing obligation.[5] However, Bell Atlantic's charts rely upon incorrect and unjustified applications of the sharing mechanism. In chart 1-1, Bell Atlantic tries to show that, without add-back, a LEC that earned 12.90% in the first year would earn precisely 12.25% in every subsequent year, after sharing. However, Bell Atlantic treats the sharing adjustment in year 2 as permanent, rather than as a one-year adjustment.[6] Since the year 2 sharing amount must be reversed, the LEC would earn 12.90% in year 3. This would produce another sharing adjustment in year 4, resulting in the "see-saw" effect described in the <u>NPRM</u>. Over the five-year period, the failure to include add-back would cause the LEC to share less than half of the correct amount.[7]

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4 <u>See</u> Bell Atlantic Workpapers; Ameritech Exhibit 1; MCI Table 1; US West Table 1.

5 Bell Atlantic at pp. 2-3.

6 This may occur because Bell Atlantic reverses the sharing adjustment twice each year in Chart 1-1, as it does in charts 1-3, 1-4, 2-1 and 2-2. <u>See</u> discussion <u>infra</u>.

7 Bell Atlantic also incorrectly computes the year 2 sharing obligation as being equal to the line 11 total of excess earnings subject to sharing, rather than to the after tax sharing amount.

In chart 1-2, Bell Atlantic tries to show that add-back "reverberates" in subsequent years, producing sharing in excess of 100% of earnings over time.[8] However, chart 1-2 treats the cumulative sharing obligation, with add-back, as arising solely from the earnings in year 1. This is incorrect. The total price cap sharing obligation on line 15, if it included reversal of the previous year's sharing each year and add-back of sharing in the current year's revenues, would properly show a sharing amount of $23 million _each year_, corresponding to the amount of sharing that the LEC should make based on an underlying rate of return of 12.9% for each year. The cumulative sharing that Bell Atlantic shows is _too low_ because it fails to include the effect of each year's sharing reversal on the revenues on line 1, which produces an incorrect rate of return on line 5 before sharing.[9]

Bell Atlantic's charts on the effect of add-back on the LFA are similarly flawed. In chart 1-3, Bell Atlantic includes productivity changes (_i.e._, expense changes) in years 2 and 3 that are sufficient to eliminate the need for a LFA. In effect, Bell Atlantic assumes that the LEC exceeds the 3.3 percent productivity standard that the Commission adopted in

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8 _See_ Bell Atlantic at p. 3.

9 Chart 1-2 has other errors. As in chart 1-1, Bell Atlantic applies a permanent revenue reduction of $26 million after year 1, despite the fact that the sharing amount from year 1 should be reversed after year 2. In addition, Bell Atlantic added back only $12 million in year 2, based on the half-year effect of sharing, even though it reduced revenues in line 1 for the full-year effect of sharing. This chart is hopelessly muddled and it cannot possibly show any valid results.